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SUBJECT: MORE VIEWS ON PROSPECTS FOR ECONOMIC REFORM

Classified By: Ambassador William Burns for Reasons 1.5 (b) and (d).

Summary

[¶1.](#) (C) In a series of meetings March 20, NSC Senior Director Mary Warlick and the Economic Minister Counselor solicited the views of a variety of Russian interlocutors on the prospects for economic reform under President-elect Medvedev. From those meetings, we offer three disparate but representative views: from a government insider, who said reform is coming; a government critic, who expressed skepticism; and an independent analyst, who said reform was possible, but only if the country's current economic boom begins to flag. End Summary.

The Government Insider

[¶2.](#) (C) Presidential Expert's Head Arkadiy Dvorkovich told Warlick he had recently helped organize a briefing for President-elect Medvedev on the global financial crisis. He said the outside experts he had brought in had told Medvedev that as a result of turmoil elsewhere, capital markets were closing for most Russian firms, with costs rising rapidly for those who could still access foreign debt. The result was likely to be a slowdown in both the global and Russian economies, though hopefully only a moderate one.

[¶3.](#) (C) Dvorkovich said that despite this environment, Medvedev was committed to the economic reforms he had spelled out in his February Krasnoyarsk speech. Dvorkovich said he had played a role in drafting the speech, which would form the basis of Medvedev's policy agenda. The emphasis would be on adding more value in the economy and improving productivity. An early emphasis was likely to be reforming tax policy. There was a debate within the GOR over whether tax cuts should be general or sector specific. Dvorkovich claimed the package would include both a general reduction in the VAT, as well as targeted incentives such as accelerated depreciation and tax breaks, research and development, and education and training. In addition, there was a debate over how far to cut taxes, with Finance Minister Kudrin arguing for smaller cuts.

[¶4.](#) (C) Longer-term, Dvorkovich said Medvedev was likely to care most about judicial and law enforcement reforms, which reflected his legal background. There would be legislative changes to prevent criminal pressure being applied to firms, especially small and medium sized enterprises. Another change envisioned was substituting time-consuming and

bribery-inducing bureaucratic permissions for simple declarations of compliance, which would be subject to audits.

15. (C) Dvorkovich defended current Russian economic policy, noting that despite rising inflation, the percentage living in poverty had fallen to 14 percent of the population, while the middle class had grown to 20 percent. He predicted those trends would continue under Medvedev as the quality of life of the large lower middle class continued to improve. He acknowledged that inflation hit the poor hardest, but noted pensions were being indexed to the higher rate of inflation for their basket of goods. Dvorkovich added that the pension system would be supported by the Future Generation Fund, an off-shoot of the Stabilization Fund. This would ensure its long-term viability.

16. (C) Dvorkovich stressed that there would be a continuing strong role for the state in the economy. The Strategic Sector Law, which was finally ready after two months of intense intra-governmental negotiations, identified a number of economic sectors where it was natural for the state to take the lead, including aerospace, ship-building, and of course oil and gas. However, in other sectors, such as power generation and transport, it was more appropriate for the private sector to lead. The law would provide clarity for investors. Importantly, the commission that would implement the law would have more "liberals" than members of the so-called power (or security and defense) ministries.

The Critic

17. (C) Former Deputy Energy Minister and now outspoken Kremlin critic Valdimir Milov told Warlick not to expect economic liberalization under Medvedev, who Milov asserted would favor economic asset redistribution over structural reform. He pointed to Medvedev's having shut down Presidential Advisor and G-8 Sherpa Igor Shuvalov's reforms in 2003 and claimed that the National Priority Projects had been ineffectual window dressing. In addition, Medvedev's key economic advisors -- Dvorkovich, Economic Minister Nabiullina, and Deputy Economic Minister Voskresenskiy might be considered "liberals" but all in fact favored a strong state role in the economy. The main change to expect under Medvedev would be a new group of elites controlling the country's key means of productions and materially benefiting as a result.

18. (C) Milov said that any fundamental change was unlikely absent an external shock that caused the current system to deteriorate, such as a dramatic drop in oil prices. However, this was possible given that much of Russia's current economic growth was driven by cheap capital internationally. Even with rising oil prices there could still be problems if Russian companies were unable to continue borrowing from abroad due to the global financial crisis. Moreover, the system itself was brittle and could deteriorate if elite in-fighting continued over productive assets. Milov marginalized the importance of Presidential Advisor Igor Sechin -- who he stated had been a significant player only in the Yukos affair -- and predicted that he would ultimately be dismissed from the Kremlin and from his position as Chairman of the Board of Rosneft.

The Independent Analyst

19. (C) Investment Bank Troika Dialogue's Chief Economist, Yevgeniy Gavrilenkov, told Warlick that Medvedev and the GOR would be unlikely to embrace structural economic reforms in the current good times. Russia only embraced reform when times were tough. When times were easy, the system became corrupt, as it was today. For example, economic reform under Putin had stopped in 2003 when oil prices began to rise. Gavrilenkov dismissed talk of looser fiscal policy, noting that it was already quite expansionary, with a 42 percent

injection of liquidity in the fourth quarter of 2007 alone. Much of that money had gone to state corporations, fueling not only inflation but corruption and inefficiency. He said the money given to the state corporations essentially had been bribes. Putin had been reluctant to choose his own successor but when no consensus had emerged among the Kremlin elite, he had picked Medvedev and had distributed these funds to buy elite acquiescence. If the new administration cut taxes, as expected, without cutting spending, also as expected, that would further fuel inflation.

¶10. (C) However, Gavrilentov said the good times might end soon. He said the growth of the Russian economy had been fueled by high oil prices, which had helped the current account, and by cheap foreign credits, which had fueled a capital account surplus. He predicted narrowing surpluses in both accounts in the near future. First, oil prices did not need to fall would only need to see a slowdown in their rate of increase for the current account to turn around. Of even more concern in the short run was the capital account, where the global liquidity crisis was drying up cheap foreign capital, forcing Russian companies to refinance at higher rates or to turn to domestic sources of financing, which ultimately meant the government.

¶11. (C) Gavrilentov said what was needed in Russia was "continued growth but better growth." Being an energy exporter was not the way to develop; it involved too little value added. Moreover, the country was overly dependent on oil and gas, which along with metals accounted for 88 percent of its exports. Falling production and rising domestic demand would begin to eat away at the exportable oil and gas surplus in the near future. In that regard, the state was the wrong driver for development and diversification. Corruption was a function of the number of bureaucrats and under Putin the size of the bureaucracy had expanded rapidly, especially in the national security agencies. The state needed to reduce its role and control over the economy to improve the quality of growth.

Comment

¶12. (C) The three views on the likelihood of significant, market-oriented reforms under Medvedev reported here are broadly consistent with what we have found elsewhere: optimism that needed change may be coming, tempered by realism that the environment may not be conducive and that vested interests will resist.

¶13. (U) NSC Senior Russia Director Warlick cleared this cable.
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